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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 791

LILY HO QUON AND ALBERT T. QUON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 31–40) are not reported. The opinion of the Circuit Court of Appeals (R. 54) is reported at 165 F. 2d 215.

JURISDICTION

The judgment of the Circuit Court of Appeals (R. 55) was entered on January 2, 1948. A petition for rehearing was denied on February 11, 1948. (R. 56). The petition for a writ of certiorari was filed on May 8, 1948. The jurisdiction of this Court is invoked under Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, on the facts found by the Tax Court, petitioners, husband and wife, are taxable under Section 22 (a) of the Internal Revenue Code upon part of the income of certain trusts set up by them, for the benefit of their four minor children, out of one-half of the assets of an alleged family partnership, the business of which previously had been conducted by the husband as a sole proprietorship.

STATUTES INVOLVED

Internal Revenue Code:

> SEC. 22. GROSS INCOME.
>
> (a) *Deneral Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U. S. C. 1940 ed., Sec. 182.)

STATEMENT

This proceeding involves deficiencies in federal income taxes asserted against each of the petitioners in the sum of $9,835.08 for the taxable year 1941. (R. 31, 40, 41.) The facts found by the Tax Court are as follows (R. 32–38):

The petitioners are husband and wife residing in Los Angeles, California.[1] The husband, Albert T. Quon, is a resident alien. His wife, Lily Ho Quon, is a citizen. Prior to May, 1941, the husband, as sole proprietor, operated a business under the name of Quon-Quon Company. The business involved importing Chinese decorative merchandise and wholesaling it. (R. 32.)

[1] The husband, Albert T. Quon, is sometimes referred to herein as the taxpayer, while both are sometimes referred to jointly as the taxpayers.

On May 1, 1941, the taxpayers, as co-settlors, created four separate trusts, one for each of their four children, then ranging in age from ten to four years, respectively. The children are all citizens. Concurrently with the creation of these trusts Quon-Quon Company was reorganized as a partnership, the taxpayers being constituted general partners and the trustees of the four trusts being constituted limited partners. (R. 32.)

All of the four trusts, to the extent material here, are essentially similar except for the identity of the beneficiaries and the trustees.[2] The trust indentures (R. 15–22) recite that Albert T. Quon "owns and operates" Quon-Quon Company, which business was community or joint property of the taxpayers, and that they desired to make provision and settlement for the designated child by irrevocable transfer, in trust, of an interest in such business (R. 15). The taxpayers, as co-trustors, thereupon assigned to the named trustee an undivided 12½ percent interest in the business of Quon-Quon Company, subject to the terms of a partnership agreement executed concurrently therewith under which the taxpayers were to be general partners and the several trustees were to

[2] The Tax Court referred to the pertinent provisions of the trust for their son, Ronald, as typical of the material provisions of all of the trusts (R. 32–35), but the trust for the benefit of a daughter, Lillian Mae, is the only one included in the printed record (R. 15–22).

be limited partners. The trust instruments provided (R. 16) that concurrently with the execution thereof the business should be reorganized as a limited partnership and that the trustee should become a limited partner therein. As such limited partner and as trustee under the trust indenture he was to have a 12½ percent interest in the business and was to receive 12½ percent of the net profits, to be credited to and distributed to him from time to time, pro rata, with distributions to the general partners. Upon termination, dissolution, or reorganization of the business the trustee had power to reinvest his distributive share of the proceeds therefrom, or any part thereof, in the capital assets or capital stock of any partnership, corporation or other company which may be organized for the purpose of acquiring the assets and continuing the business of the partnership. (R. 17.)

Under the trust indentures the trustee was further authorized to sell or exchange trust assets, purchase other assets, invest trust funds or borrow money and obligate or encumber the trust estate therefor, but all only with the written consent of the beneficiary after she attained 21 years of age, or only with the written consent of the parents or legal guardian of the beneficiary prior to that time. (R. 17.)

The trust instruments further provided that when the beneficiary reached the age of 21 years, the trustee should thereafter pay him or her from

the income or principal, or both, of the trust estate such amount as in the trustee's discretion would be necessary to maintain the standard of living to which he or she had been theretofore accustomed, if the parents or surviving parent were not ready, willing, and able to provide such funds for the beneficiary. (R. 18.)

The trust instruments further provided that when the beneficiary reached the ages of 21, 25 and 30 years, the trustee should pay him or her, respectively, one-fourth, one-third, and one-half of the then accumulated income and principal of the trust estate other than the partnership interest in Quon-Quon Company. When the beneficiary reached the age of 35 years the trustee was to pay him or her the entire remainder of the estate and the trust was to terminate. If the beneficiary should die before attaining the age of 21 years, the trust estate was to go to his or her issue or, if none, equally to the remaining trusts. If the beneficiary should die after reaching the age of 21 years, the trust estate was to go to his or her heirs, devisees, or legatees. (R. 18–19.) Other provisions of the trusts (R. 20–21) are not material here.

Concurrently with the creation of the above trusts, Quon-Quon Company was reorganized into a purported limited partnership. The taxpayers were general partners, each having a 25 per cent interest, and the four trustees of the four trusts

were limited partners, each having a 12½ per cent interest in the partnership. Each general partner contributed to the partnership an undivided 25 per cent interest in the business of Quon-Quon Company. Each limited partner contributed to the partnership an undivided 12½ per cent interest in the partnership business, each such 12½ per cent interest being valued at $11,268.06. (R. 35.)

The alleged partnership is for a term of 25 years. It can be dissolved by the death of a general or limited partner, the transfer or attempted transfer of the interest of any general or limited partner, the retirement or withdrawal from the partnership of any general or limited partner. The substitution of a successor trustee as a limited partner will not operate to dissolve the partnership. (R. 35.)

Each limited partner and the general partners agreed to contribute to the partnership capital a pro rata amount, based on his or her respective interest in the partnership assets and profits, but only out of his or her share of the net profits from the business, sufficient in the aggregate to pay all obligations of the business theretofore or thereafter incurred, and to provide adequate working capital. No definite time was agreed upon for the return of the contributions of the limited partners. Their pro rata shares of the capital assets of the partnership were to be returned to them concur-

rently and pro rata with distributions to the general partners, upon termination of the partnership and liquidation of its assets. (R. 26–27, 35–36.)

As early as 1939 the taxpayer discussed the advisability of creating trusts for his children but nothing was then done. After his return from a business trip to China in August, 1940, he became concerned over the possibility that his business assets might be frozen by executive order since certain alien property in this country was becoming subject to such controls. The plan to create the trusts and the partnership was prompted by various considerations. One consideration was the taxpayer's parental desire to make provision for the security of his children. Another consideration was the fear of having the assets of his business frozen by the Government, and since his children and wife were citizens partial ownership of the business assets by them was considered a practical method of avoiding seizure to that extent. Another consideration was the reduction of taxes. (R. 36–37.)

After creation of the so-called partnership, the business of Quon-Quon Company continued to be conducted in all material respects in the same manner as it had been conducted prior to the partnership. The limited partners played no part in the conduct of the business. Capital and drawing accounts were set up on the partnership books for each limited partner. To each limited partner's capital account was credited 12½ per cent of the

partnership's net profit. Checks were drawn from time to time by the taxpayer on the partnership's commercial account, payable to various banks and brokers, which checks were ratably charged against the limited partners' drawing accounts. These checks were drawn to purchase securities which were delivered by the taxpayer to the trustees. Later the trustees themselves directly purchased securities for the trusts from the amounts credited to them on the partnership books. These purchases were approved by the taxpayers as parents of the beneficiaries. (R. 37.)

On the taxpayers' income tax returns for 1941 the income of Quon-Quon Company from January 1, 1941, to April 30, 1941, inclusive—the period prior to formation of the so-called partnership—was shown in the amount of $40,580.19, which amount included the husband's salary of $4,000 from the partnership for the eight month period, May to December, inclusive. This amount was also reported on a community property basis. Each trust reported as its share of the partnership income for 1941 the amount of $9,094.94, or an aggregate amount of $36,379.76, for the four trusts. In determining the deficiencies here involved the Commissioner added one-half of this latter amount, or $18,189.88, to the income of each of the taxpayers. (R. 37–38.) In determining the deficiencies here involved the Commissioner held that the income reported by the four trusts was taxable to the taxpayers under Sec-

tions 22 (a), 166 and 167 of the Internal Revenue Code. (R. 13–14, 38.) In its opinion (R. 38) the Tax Court held that on the foregoing facts this case is controlled by the decisions of this Court in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293. The Circuit Court of Appeals affirmed without opinion. (R. 54.)

ARGUMENT

This is another case involving the taxation, for federal income tax purposes, of the income of a so-called family partnership. The case was correctly decided by the Tax Court and the court below, and no question is presented here which would justify the granting of a writ of certiorari. The courts below properly applied the criteria established in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, and the decision is in accord with numerous other cases in the Circuit Courts of Appeals and the Tax Court.

We have here a situation wherein a sole proprietorship originated, operated and controlled by petitioners is converted into a partnership which purports, by trust mediums, to include as limited partners petitioners' minor children. No capital not originating with petitioners has been contributed by the trusts. No services are contributed to the partnership by the trustees. The business for all practical purposes continues to be

operated and controlled the same after conversion to the partnership as it was before.

As this Court pointed out in the *Tower* case, *supra* (p. 286), a partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business, and when there is a community of interest in the profits or losses. But no such arrangement was intended or accomplished here. The Tax Court found the considerations prompting the taxpayer to make the arrangements here involved were a parental desire to provide for the security of his children, an attempt to avoid freezing his business assets by the Government, and reduction of taxes. (R. 36–37.) No new capital was contributed and no new services were performed by the trustees or their beneficiaries.

In the *Tower* and *Lusthaus* cases, *supra,* this Court indicated that the decisive question in such family arrangements is not who owns a share of the capital, but who produced the income. In those cases this Court held that family partnerships erected upon gifts or unreal assignments of business capital, though valid and enforceable under state law, are without federal income tax significance if the arrangement produces no substantial change in the creation or production of the business income, but merely represents a reallocation of such income within the family group.

Unless the donee or assignee "invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is justified in concluding that the donee or assignee is not a real partner for tax purposes. Furthermore, this Court clearly indicated in the *Tower* case, *supra* (p. 287), that the Tax Court's determination as to the reality of a so-called family partnership for federal income tax purposes is final and not reviewable if supported by substantial evidence.

The taxpayer assigns as one ground for the granting of the writ here the alleged misapplication of this Court's decisions in the *Tower* and *Lusthaus* cases, *supra.* (Pet. 7.) But the purported distinction between the instant case and the cases just cited (Br. 11–17) is without material substance. Purported assignments of ownership of the business capital to members of the family other than the other spouse do not give rise to a real partnership for purposes of the federal income tax. *Scherf* v. *Commissioner,* 161 F. 2d 495 (C. C. A. 5th), certiorari denied, 332 U. S. 810; *Wilson* v. *Commissioner,* 161 F. 2d 556 (C. C. A. 4th), certiorari denied, 332 U. S. 769; *Fletcher* v. *Commissioner,* 164 F. 2d 182 (C. C. A. 2d), certiorari denied March 15, 1948,

No. 566, present Term; *Appel* v. *Smith,* 161 F. 2d 121 (C. C. A. 7th).

The above principles are no less applicable where, as here, the gift is to trustees for the benefit of the taxpayer's children. Passage of titular ownership of a portion of the business capital to a fiduciary instead of directly to the donee affects the legal form but not the economic substance of the arrangement. *Belcher* v. *Commissioner,* 162 F. 2d 974 (C. C. A. 5th), certiorari denied, 332 U. S. 824; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C. C. A. 3d), certiorari denied, 332 U. S. 767; *Hash* v. *Commissioner,* 152 F. 2d 722 (C. C. A. 4th), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Dawson* v. *Commissioner,* 163 F. 2d 664 (C. C. A. 6th); *Benson* v. *Commissioner,* 161 F. 2d 821 (C. C. A. 5th); *Losh* v. *Commissioner,* 145 F. 2d 456 (C. C. A. 10th).

In the instant case the Tax Court's findings fail to disclose a real business purpose in the arrangement effected in the taxable year, and it is clear from the Tax Court's opinion (R. 38–40) that it was unable to find that a bona fide partnership had been created for federal income tax purposes. The record fully supports its conclusion and the court below affirmed it without comment. (R. 54.) It was unnecessary to consider the wife's status as a partner because of the community character of the earnings of the

business. But here, as in the *Tower* and *Lusthaus* cases, *supra,* and cases cited above, every ingredient productive of the business income in question—capital, services, control and management—emanated from the taxpayer or the marital community. The case is indistinguishable from *Belcher* v. *Commissioner, supra, Eisenberg* v. *Commissioner, supra, Hash* v. *Commissioner, supra, Dawson* v. *Commissioner, supra,* and *Benson* v. *Commissioner, supra.*

The decision below is not in conflict with any of the decisions relied upon by the taxpayer. (Pet. 8–9; Br. 17–23.) None of them except *Thomas* v. *Feldman,* 158 F. 2d 488 (C. C. A. 5th), involved the taxation of a partnership. The *Feldman* case is not in point because in that case the trial court had found as a fact that a bona fide partnership had been created and the Circuit Court of Appeals merely affirmed its decision because the finding was supported by the evidence. The other cases, except *Oyama* v. *California,* 332 U. S. 633, are cited by the taxpayer as authority for the argument that his purpose to avoid the effect of possible government freezing orders was a valid business purpose, and the latter is cited for the proposition that the bona fides of the so-called partnership cannot be questioned under the circumstances of this case. The cases are inapplicable, and the arguments are without merit here.

CONCLUSION

The decision of the court below is correct. It is fully supported by the facts and the law, and is not in conflict with any other decision. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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